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In the

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1973

No. ~~73~~ - 374

UNION EQUITY COOPERATIVE EXCHANGE INC.,
Petitioner,

VERSUS

COMMISSIONER OF THE INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

FRANK CARTER
Bass Building
Enid, Oklahoma

Counsel for Petitioner

of Counsel:

CARTER & CARTER
Bass Building
Enid, Oklahoma

August, 1973

UTTERBACK TYPESETTING CO., 519 W. CALIF., OKLAHOMA CITY, PH. 235-0030

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COMMISSIONER OF THE INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Union Equity Cooperative Exchange Inc., your Petitioner, prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit, entered in the above entitled case on July 2, 1973, with mandate stayed until August 26, 1973.

OPINIONS BELOW

The court rendered its opinion adversely to its Petitioner, on July 2, 1973, a copy of which is hereto attached and marked Appendix "A."

Thereafter, on July 17, 1973, your Petitioner filed its application for a stay of the mandate, pending an appli-

cation to the United States Supreme Court for a Writ of Certiorari, a copy of which is (Appendix "B").

On July 27, 1973, the Circuit Court stayed the Order and Decree and stayed the mandate until August 26, 1973, pending the timely filing by your Petitioner for a Petition for a Writ of Certiorari in the Supreme Court of the United States, a copy of which is (Appendix "C").

JURISDICTION

The judgment of the Court of Appeals was entered on July 2, 1973. A Motion to Modify the Decree, and an Order staying the mandate until August 26, 1973 was entered on July 27, 1973. The jurisdiction is invoked under the provisions of Title 28, U.S.C.A. 1254 (1).

STATUTES AND REGULATIONS INVOLVED

Oklahoma Statutes Annotated, Title 18, *Corporations*

Title 18, § 1.132, Dividends payable in cash or property:

> "a. Subject to any further limitations or restrictions in the articles of incorporation, a domestic corporation may, by resolution of its board of directors, declare and pay dividends in cash or property only as follows:
>
> "(1) Out of earned surplus; . . ."

Oklahoma Statutes Annotated, Title 18, *Corporations*

Title 18, § 1.70, Books of account:

> "Except as otherwise provided in Section 16 of this Act, every corporation shall keep and maintain adequate and correct accounts of its properties and busi-

ness transactions, including accounts of its assets, liabilities, receipts, disbursements, gains, losses, capital, surplus, and shares. The books of account shall at all reasonable times be open to inspection by any director. Laws 1947, p. 110, § 70."

Oklahoma Statutes Annotated, Title 2, *Agriculture*

Title 2, § 361 w, Application of general business corporation laws:

"The provisions of the general business corporation laws of this State and all powers and rights thereunder shall apply to the associations organized hereunder, except where such provisions are inconsistent with the express provisions of this Act. Laws 1937, p. 268, §24."

Oklahoma Statutes Annotated, Title 2, *Agriculture*

Title 2, § 361 L, Dividends and Earnings:

"(b) Dividends and Earnings. The directors, subject to the revision by the members or stockholders, at any general or special meeting lawfully called shall apportion the net earnings thereof from time to time at least once in each year. Such apportionment shall not be made until not less than ten (10) per cent of any undistributed balance accruing since the last apportionment, has been set aside in a surplus or reserve fund unless such surplus or reserve funds equal at least one hundred (100) per cent of the paid up membership fees or capital stock.

"(c) An association shall limit the interest it pays on membership capital or stock to an amount not greater than eight (8) per cent per annum.

"(d) Undistributed balances from any source, in excess of additions to reserves and surplus, shall be

distributed on the basis of patronage, that is according to the amount or value, as the association may decide, of the products sold to or through, and/or purchased from or through, the association by its patrons. . . ."

U.S.C. Annotated, Title 26, Internal Revenue Code

Title 26, § 461, General rule for taxable year of deduction:

"(a) General rule.—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."

U.S.C., Title 26, § 172

[¶14,561] Code § 172. Net Operating Loss Deduction:

"(a) Deduction Allowed.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term 'net operating loss deduction' means the deduction allowed by this subsection. . . ."

QUESTIONS PRESENTED

(1) Whether or not the patrons of a duly organized Farm Cooperative, in Oklahoma, can be deprived of the right to receive their *patronage dividends* (representing their own money, and to pay taxes thereon themselves), without being subjected to the levy of a separate and additional Corporate tax being assessed thereon by the Commissioner, and per force, paid, and deducted by their Marketing Cooperative?

(2) Whether or not the patrons of a Farm Cooperative through their by-laws, and directors, have the right to require their cooperative to pay stock dividends from *surplus reserves* without reducing their patronage dividends?

(3) Which of the conflicting decisions of the Fifth Circuit Court of Appeals (326 F.2d (569), and the Eighth Circuit (448) F.2d (776) involving the same issues as presented in this case, should prevail?

A Certificate of Service has been prepared, and is hereto attached.

STATEMENT OF THE CASE

Union Equity Cooperative Exchange Inc., your Petitioner, hereinafter referred to as "UNION EQUITY" is an Oklahoma Cooperative Marketing Association doing business pursuant to the Oklahoma Marketing Act, and the Capper-Volstead Act (R. 41).

It has been so engaged, since its date of incorporation in October of 1929 (R. 41).

Its principal office is and was on January 22, 1970, in Enid, Oklahoma.

As of the close of business on March 31, 1963, Union Equity was doing business as a *non-exempt* cooperative. Since that date, pursuant to a letter of exemption granted under IRC 521, Union Equity has carried on business as an *exempt* farmers cooperative.

During the critical periods involved in this proceeding, its fiscal and tax year, extended from April 1, to March 31 of each year.

That it filed its annual tax returns for the years 1961, 1963, and 1964, and which were duly filed by its competent and outside accountants.

For the taxable year, ending March 31, 1963, your Petitioner from the earnings, paid tax on $476,410.65, which it transferred to its surplus reserve, and for the year ending March 31, 1964, it allocated $245,112.50 pursuant to its by-laws and actions of its Board of Directors to its general reserve, and thereupon declared a 2½ per cent dividend on the outstanding stock. (Union Equity paid tax on the $245,112.50 for its tax year ending March 31, 1964, even though it was then "exempt.")

Thereafter, and on October 30, 1969, the Commissioner of Internal Revenue issued a notice of deficiency, claiming in substance:

1. That for the year ending March 31, 1963, there was a deficiency of $138,164.30 in taxes, and for the taxable year ending March 31, 1961, in the amount of $81,267.77.

These were asserted taxes on amounts paid out by the Company, to its patrons, representing their earnings for patronage. The Commissioner contended that these were amounts which represented taxes due on improperly distributed "patronage earnings." (Even though these amounts definitely represented sums due the patrons (under Charter and By-Law) by virtue of their business with the Petitioner during those years.)

On appeal to the Tax Court, the Tax Court finally adjudicated in favor of the Commissioner.

A Petition for Review was filed with the Tenth Circuit Court of Appeals.

The Tenth Circuit Court of Appeals then, after several weeks, and upon the dates hereinabove indicated, rendered its opinion and order adversely to your Petitioner (Appendix "A").

ARGUMENT

THE PATRONAGE DIVIDENDS PAID BY PETITIONER TO ITS MEMBER PATRONS, REPRESENTING THEIR PROPORTIONATE SHARE OF THE EARNINGS DEVELOPED BY BUSINESS TRANSACTED BY THEM WITH THE PETITIONER DURING THE YEAR ENDING MARCH 31, 1963, BELONGED EXCLUSIVELY TO THEM, AND CANNOT BE ERODED OR DILUTED.

In support of this assertion, Petitioner alleges that it is fully fortified by the holding and decision in the case of *U. S.* v. *Mississippi Chemical Company* (U. S. Court of Appeals, Fifth Circuit No. 19418, decided January 9, 1964, 326 F.2d 569).

This case was first tried to a Federal jury in Vicksburg, Mississippi, with proper instructions given by the court; and pursuant to the verdict of the jury, the court rendered a judgment in favor of the taxpayer, which involved a very similar and analogous situation as now presented by Union Equity Cooperative Exchange.

Mississippi Chemical was a Consumer Cooperative. The factual situation only differs from the instant case before the Court in that Mississippi Chemical was a farmers cooperative, engaged in the supply of fertilizer to its mem-

bers, as a non-exempt cooperative, and to others; while Union Equity is a *marketing* farmers' cooperative engaged in the storage and marketing of wheat and grain for its members, and non-members.

In the *Mississippi Chemical* case, herein referred to, pursuant to its pre-existing obligations contained in its charter and by-laws, it paid out some $680,000.00 during a period of four years, representing patronage refunds.

The government objected for the reason that such payments were in excess of the amounts which would have been payable under the formula set forth in its AFF 6967. The company contended, as the Petitioner does in this case, that such payments did not constitute income to the taxpayer but belonged to the stockholder patrons under their legally enforceable contract; and that said sum never became the property of the corporation.

The District Court held in favor of the taxpayer, after a trial by jury, and proper instructions by the court, which is cited in 7 AFTR2d 650; and in support thereof, cited the cases of *San Joaquin Valley Poultry Producers Association* v. *Commissioner*, 136 F.2d 382; *Farmers Cooperative* v. *Birmingham*, 86 F.Supp. 201; *Colony Farms* 688; *Saenger* v. *Commissioner*, 69 F.2d 613; and *State of Mississippi* v. *Morgan Gin Company*, 189 So. 187.

That case was decided February 7, 1961.

It was appealed by the Commissioner, to the United States Court of Appeals, for the Fifth Circuit, and was affirmed by that Court on January 9, 1964, and is reported in 326 F.2d 569.

In that case, it was urged on appeal by the government that in the distributions made by Mississippi Chemical, it had not complied with the applicable regulations promulgated by the department.

In affirming the decision of the lower court, the Fifth Circuit among many other pertinent determinations held:

> "The Treasury Department cannot, by interpretative regulations, make income of that which is not income within the meaning of the Revenue Acts of Congress. Treasury regulations can add nothing to income as defined by Congress."

On checking the procedures applicable to a review of this case of the Fifth Circuit, we find that no writ of certiorari was ever granted.[1]

The case of Union Equity, as currently submitted to this Honorable Court, is to all intents and purposes perfectly analogous and is entitled to serious consideration.

In this connection Petitioner emphasizes the contents and relevancy of ¶20 of the Stipulation. (See App.)

In this paragraph it is tacitly stipulated that for thirteen years, since 1950 (as a matter of fact, for nineteen years—until 1969), the method of accounting adopted and utilized by Petitioner in computing its patronage dividend deductions, had always charged its capital stock dividend to non-member business or to the surplus reserve. And that during those years the Internal Revenue Service had made periodic audits of Petitioner's tax return and the

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[1] Incidentally this case was tried and won by Mr. Satterfield of Mississippi, past President of the American Bar Association—representing the Taxpayer.

question of proper allocation of stock dividends had never been previously questioned by the examining agent.

This practice, of course, on the part of the Respondent raises immediately the question of: "Equitable Estoppel." In other words, as the result of this consistent method of paying dividends on capital stock out of non-member business, or out of the surplus reserve, by this Petitioner, Respondent has fortified the encouragement of this Petitioner to follow the "Law of Cooperation" and to insulate all possible net earnings of member-patrons against the encroachment into their earnings.

All recipients of such dividends of patronage are required to report them as taxable income and to pay tax thereon at their respective rates.

After nineteen years of conformity with this method of accounting being followed by Petitioner, and with full reliance upon the tacit agreement of the Respondent that Union Equity was in compliance with the law, it would be obviously inequitable to abruptly force this Petitioner to accept and adhere to an adverse ruling on this assessment for the years 1963 and 1964.

THE CONFLICT IN DECISIONS BY THE FIFTH, EIGHTH, AND THE TENTH CIRCUIT, ESPECIALLY DESERVES ATTENTION FROM THIS COURT, IN ORDER TO RESOLVE SUCH CONFLICTS.

Reference has been made *supra* to the case of *U. S.* v. *Mississippi Chemical Company,* Fifth Circuit, 326 F.2d 569.

In all fairness, it should be pointed out in this Petition that there does not exist a contrary decision from the Eighth Circuit Court of Appeals.

We refer to the case of *Des Moines County Farm Service Company* v. *U. S.*, 324 F.Supp. 1216 (S.D. Iowa 1971), *affirmed* 448 F.2d 776, by the Eighth Circuit.

The *Des Moines* case, above referred to, had a very similar tax situation as encountered by the Fifth Circuit, in the *Mississippi* case, and also by the current case of Union Equity, in the Tenth Circuit. In the *Des Moines* case, *supra*, the Court sustained the Internal Revenue Service, but did so in the opinion of your Petitioner, entirely without recognition of the rights of the individual producer, who was a patron of the organization, and who under the many rules and regulations set forth for the protection of member patrons was entitled to payment without adulteration or reduction.

Under the theory of a farmers' cooperative association, the farmer producer is entitled to all of his share of the proceeds derived from the marketing of his product. There is no provision whatever in either of the State or Federal acts which authorize the dilution of his patronage dividends.

In the Iowa case, *supra*, the Court arbitrarily reduced his interest in the cooperative (proceeds from the sale of his product).

The earnings derived from the sale or marketing of the product of a member belongs to him. The cooperative is merely an agent, or "conduit," for the transmission of the value of his product to him after deducting the cost of processing and sale. It makes no difference if the cost of such sale may be reduced by other income. He is entitled to the net. Presumably the sales organization, the coopera-

tive, will utilize all legitimate means to reduce this cost, but its sole purpose is to accentuate and develop and improve the net amounts payable to the member producer, from his product.

The *Mississippi* case, *supra*, upheld this theory.

Your Petitioner feels that it is organized, and operating solely for the benefit of its member producers. If it develops any additional income from non-members, that amount, under the laws of Oklahoma as indicated herein, may be transferred to surplus and dividends paid on stock therefrom without invasions of the amounts and proceeds due to the producers from their respective deliveries and sales through the cooperative.

For authorities justifying assumption of jurisdiction of the United States Supreme Court, relating to cases involving previous conflicts of decisions concerning the same or similar questions, see the following:

—*Waterman S. S. Corp.* v. *U. S.*, Ala. 1965, 85 S.Ct. 1389, 381 U.S. 252, 14 L.Ed.2d 370, *rehearing denied* 86 S.Ct. 17, 382 U.S. 873, 15 L.Ed.2d 114;

N.L.R.B. v. *Metropolitan Life Ins. Co.*, R.I. 1965, 85 S.Ct. 1061, 380 U.S. 438, 13 L.Ed.2d 951;

Jarecki v. *G. D. Searle & Co.*, Ill. 1961, 81 S.Ct. 1579, 367 U.S. 303, 6 L.Ed.2d 859;

Knetsch v. *U. S.*, Cal. 1960, 81 S.Ct. 1579, 367 U.S. 303, 6 L.Ed.2d 859;

Federal Power Commission v. *Tuscarora Indian Nation*, App. D.C. 1960, 80 S.Ct. 543, 362 U.S. 99, 4 L.Ed.2d 584, *rehearing denied* 80 S.Ct. 858, 362 U.S. 956, 4 L.Ed.2d 873;

Mitchell v. *Robert De Mario Jewelry, Inc.*, Ga., 1960, 80 S.Ct. 332, 361 U.S. 288, 4 L.Ed.2d 323;

U. S. v. *Price*, Ariz. 1960, 80 S.Ct. 326, 361 U.S. 304, 4 L.Ed.2d 334;

Monroza v. *Carbon Black Export, Inc.*, Tex. 1959, 79 S.Ct. 710, 359 U.S. 180, 3 L.Ed.2d 723, *rehearing denied* 79 S.Ct. 1115, 359 U.S. 999, 3 L.Ed.2d 986;

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CIR v. *Hansen*, 1959, 79 S.Ct. 1270, 360 U.S. 446, 3 L.Ed.2d 1360;

F.T.C. v. *Flotill Products, Inc.*, Cal. 1967, 88 S.Ct. 401, 389 U.S. 179, 19 L.Ed.2d 398.

CONCLUSION

Your Petitioner therefore respectfully represents to the Court that there apparently does exist a difference in the theory of cooperatives, between and among the Fifth, Eighth, and Tenth Circuit; and that it should be resolved by this Court at the earliest possible date.

HENCE this Petition of a Writ of Certiorari.

Respectfully submitted,

FRANK CARTER
Bass Building
Enid, Oklahoma

Counsel for Petitioner

of Counsel:

CARTER & CARTER
Bass Building
Enid, Oklahoma

August, 1973

CERTIFICATE OF SERVICE

Three true and correct copies of this petition for writ of certiorari have this day been mailed, postage prepaid, to:

Honorable Scott Crampton
Asst. Attorney General
Tax Division, Department of Justice
Washington, D. C. 20530

Department of Justice, Washington
Tax Division
Attn: Mrs. Carolyn Just
Washington, D. C. 20530

Mr. Howard K. Phillips, Clerk
United States District Court
Tenth Circuit
Denver, Colorado Mailed one copy

FRANK CARTER

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Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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Bass Building
Enid, Oklahoma

Counsel for Petitioner

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CARTER & CARTER
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UTTERBACK TYPESETTING CO., 519 W. CALIF., OKLAHOMA CITY, PH. 235-0030

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"APPENDIX A"

PUBLISH

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

FILED
United States Court of Appeals
Tenth Circuit
JUL 2 1973
HOWARD K. PHILLIPS
Clerk

MAY TERM — 1973

UNION EQUITY COOPERATIVE EXCHANGE Petitioner-Appellant, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	)	NO. 73-1722

On Appeal from the Decision of the
United States Tax Court

Frank Carter (Otjen & Carter, of Counsel, on the brief), for Petitioner-Appellant.

[APPENDIX]

Carolyn R. Just, Attorney, Tax Division, Department of Justice (Scott P. Crampton, Assistant Attorney General, Meyer Rothwacks and Leonard J. Henzke, Jr., Attorneys, Tax Division, Department of Justice, on the brief) for Respondent-Appellee.

Before MURRAH, Circuit Judge, DURFEE,* Judge, Court of Claims, and McWILLIAMS, Circuit Judge.

*Sitting by designation.

McWILLIAMS, Circuit Judge.

This is an appeal from the United States Tax Court. The Union Equity Cooperative Exchange, hereinafter referred to as the taxpayer, is an Oklahoma cooperative marketing association incorporated under the Oklahoma Cooperative Marketing Act, 2 O.S. § 361, et seq., and the so-called Capper-Volstead Act, 7 U.S.C. §§ 291-92, and was the petitioner in the tax court. The Commissioner, the respondent in the tax court, had determined that there was a deficiency in the taxpayer's income tax for the taxable year ending March 31, 1961, in the sum of $31,266.77, and in the sum of $138,164.30 for the taxable year ending March 31, 1963. The taxpayer sought review of such determination in the tax court and the judge of that court, the Honorable Bruce M. Forrester, in a carefully prepared opinion upheld the determination of the Commissioner. That opinion is now reported at 58 T.C. 397 (1972).

All material facts were stipulated to by the parties before the tax court and are set forth in detail by the tax court in its decision. Accordingly, reference to the facts in this opinion will only be made as is necessary to give meaning to the issues here presented.

The issues now before us are: (1) Was the tax court correct in sustaining the Commissioner's determination that the taxpayer, a nonexempt cooperative in the fiscal year 1963, must charge its 1963 capital stock dividend payments against net earnings derived from members as well as nonmembers, thereby decreasing the amount of the patronage dividend "deductions" allowable to the taxpayer? (2) Was the tax court correct in sustaining the Commissioner's determination that the taxpayer did not sustain an operating loss in the fiscal year ending March 31, 1964, which could be carried back to its fiscal year ended March 31, 1961, since in computing its fiscal 1964 patronage dividend deduction allowable under Subchapter T (Sections 1381-1388 of the Internal Revenue Code of 1954) it must reduce its net earnings by capital stock dividends actually or constructively paid in that year, rather than by dividends which were declared in that year but not paid till the succeeding fiscal year? And (3) was the tax court correct in holding that the Commissioner was not estopped from challenging the taxpayer's method of computation for patronage dividends in the taxable years here in question because agents of the Internal Revenue Service had not previously challenged its method of determining patronage dividends in prior years?

In our view, the tax court acted correctly in its determination of each of these matters and accordingly its decision is affirmed. We shall consider each of these matters separately.

I. Deficiency for the taxable year ending March 31, 1963.

Under the applicable law for the taxable year 1963, capital stock dividends paid by the taxpayer to its members as a return on their investment were not deductible from taxpayer's net income, the taxpayer in 1963 being a nonexempt farmers' cooperative. However, so-called patronage dividends to its members were deductible. We

realize there is some difference of opinion as to whether this is truly a "deduction," or should more properly be referred to as an "exclusion from gross income." Like the tax court, however, we shall refer to it as a deduction.

A patronage dividend represents a return by the taxpayer of the profits realized during a given year to its members in proportion to their dealings with the taxpayer during the year in question. The amounts returned, in whatever qualified form of property, are designed to be a true correction and deferred price adjustment on transactions the cooperative had with its members resulting in a net profit to the cooperative. *See* Consumers Credit Rural Elec. Cooperative Corp. v. Commissioner, 319 F.2d 475 (6th Cir. 1963).

The bylaws of the taxpayer in effect for the year 1963 provided, inter alia, for the payment from net earnings of a dividend not to exceed 5% on outstanding capital stock, with the remainder of net earnings to be distributed to its members as a patronage dividend. The bylaws in effect in 1963 did not provide for patronage dividends to nonmembers. The bylaws also provided for the separate handling of net earnings accrued on business transacted "with or for nonmembers," and the net earnings accrued on business transacted "with or for members." With this brief background, let us examine the different manner in which the taxpayer and the Commissioner would determine the patronage dividend for 1963.

For the taxable year of 1963, taxpayer's total net earnings derived from business transacted with members and nonmembers before adjustments for patronage dividends and dividends on capital stock were $1,519,884.69. During that taxable year, taxpayer's "member business" constituted 57.18% of its total business, with the remaining 42.82% representing "nonmember business." It is agreed to by the parties, and the tax court proceeded on such premise, that in the absence of evidence to the contrary the

Commissioner would assume that taxpayer's dealings with members and nonmembers were equally profitable, and thus that member business for 1963 generated 57.18% of taxpayer's net earnings, with the remainder of the net earnings being generated from nonmember business.

In its determination of the patronage dividend, the taxpayer accordingly first determined that its members generated $869,070.07 of its net earnings, this sum representing 57.18% of its total net earnings. After making certain insignificant deductions, it then distributed to its members $861,795.83 (65% in cash and 35% in capital stock) as a patronage dividend and claimed such amount as a deduction on its 1963 tax return. From that portion of the taxpayer's total net earnings deemed to have been generated from nonmember business, i.e., 42.82% of $1,519,884.69, the taxpayer paid its taxes therefrom and transferred the balance to its general or surplus reserve, and out of the latter declared a 5% capital stock dividend for its members.

It is the Commissioner's position that taxpayer's method of computing its patronage has the effect of charging the dividend on capital stock solely to the earnings generated by nonmember business and that by charging capital stock dividends only to income generated by business done with nonmember patrons, rather than ratably against total income, the taxpayer's net earnings from business done with member patrons is overstated. In his determination of the patronage dividend, the Commissioner accordingly would first deduct the capital stock dividend actually paid its members in 1963 ($439,374.44) from the taxpayer's *total* net earnings and would then allocate 57.18% of the remainder as a patronage dividend for its members. By such computation the Commissioner determined the patronage dividend to be some $223,660.36 less than that claimed by the taxpayer.

[APPENDIX]

As was noted by the tax court, the deduction of patronage dividends from the earnings of a nonexempt cooperative was not explicitly recognized by statute till the Revenue Act of 1962, which added Subchapter T to the Internal Revenue Code of 1954, although the Revenue Act of 1951 had made some reference thereto. However, for many years prior to any statutory recognition of patronage dividends, the allowance of a deduction of true patronage dividend to nonexempt cooperatives had long been an administrative practice of the Treasury Department and the Internal Revenue Service.

In order to qualify as a patronage dividend the Commissioner asserts that the following three requirements must be fulfilled:

1. The allocations must have been made pursuant to a legal obligation which existed at the time the patron transacted his business with the cooperative.

2. The allocations must have been made out of profits or income realized from transactions with the particular patrons for whose benefit the allocations were made, and not out of profits or income realized from transactions with other persons or organizations which were not entitled to participate in such allocations.

3. The allocations must have been made equitably; so that profits realized on the one hand from selling merchandise or services to patrons, and those realized on the other hand from marketing products purchased from patrons, were allocated ratably to the particular patrons whose patronage created each particular type of profit.

In support of the foregoing, *see*, for example, Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (8th Cir. 1961), and Petaluma Co-operative Creamery v. Commissioner, 52 T.C. 457 (1969).

The tax court concluded that the taxpayer's claimed patronage dividend, and more particularly its method of computation, did not meet the second of the three requirements above set out, namely, it failed to satisfy the requirement that the dividend in question "be made out of profits or income realized from transactions with the particular patrons for whose benefit the allocation was made." In thus concluding, the tax court observed as follows:

> "On the one hand the stockholder-patron receives a distribution from its cooperative solely in respect of its status as stockholder. This is a normal dividend from net earnings which is not deductible at the cooperative level in the same manner that a distribution of earnings and profits by an ordinary corporation is not deductible at the corporate level. The distributions are based on the stockholder's investment in the cooperative and represent a return on that investment—the greater the investment, the greater the dividend on capital stock.
>
> "On the other hand, the stockholder-patron also receives a distribution solely in respect of its status as patron. This latter distribution is based on its patronage with the cooperative during the year—the greater the patronage, the greater the patronage dividend.
>
> "In attributing the entire dividend paid on capital stock to nonmember business, petitioner is saying, in effect, that its stockholders have invested only in those of petitioner's operations and assets which were used to transact nonmember business. * * * We are unable to find any indication that the stockholders here invested in anything but the undivided totality of petitioner's operations and assets. By following a computational path that fails to reflect the reality underlying its mode of operation, petitioner has substituted accounting fiction for taxable fact.

"Consequently, in the absence of any evidence to the contrary, we uphold respondent's determination that the dividend paid on petitioner's capital stock was properly attributable to net earnings realized from member business and to net earnings realized from nonmember business in proportion to the business transacted with members and nonmembers respectively. Conversely, the amount of member earnings available for distribution as a true patronage dividend would have to be reduced by that part of the dividend on capital stock which was attributable to member earnings."

We generally agree with such reasoning and in support thereof *see* Des Moines County Farm Service Company v. United States, 324 F.Supp. 1216 (S.D. Iowa 1971), *aff'd. per curiam*, 448 F.2d 776 (8th Cir. 1971); *cf.* Fertile Co-Operative Dairy Ass'n. v. Huston, 119 F.2d 274 (8th Cir. 1941). The *Des Moines* case is virtually on all fours with the instant case and in that case the Eighth Circuit Court of Appeals upheld the trial court's determination that to the extent that payment of a capital stock dividend of a nonexempt cooperative was not charged ratably against *all* net earnings, the *total* amount paid to member patrons as patronage dividends was not excludable from the cooperative's taxable income.

In this court, as in the tax court, the taxpayer relies heavily on United States v. Mississippi Chemical Company, 326 F.2d 569 (5th Cir. 1964). The tax court distinguished that case from the instant case on the ground that there the trial court found as a fact that no part of the sum paid as a patronage dividend was paid, directly or indirectly, from the profits gained from business transacted with nonmembers and that on appeal the Fifth Circuit Court of Appeals characterized this finding as being "particularly correct"; whereas, in the instant case, according to the tax court, such a finding was not made, and could not have

been made, for the reason that in reaching the conclusion that it did "we [the tax court] have necessarily found that a part of the sum which petitioner called a patronage dividend was in fact attributable to profits from nonstock holder business." We need not here debate whether the *Mississippi Chemical Company* case is completely distinguishable from the instant case. It is sufficient to state that the result and reasoning of the *Des Moines County Farm Service Company* case are to us more persuasive than that of *Mississippi Chemical.*

II. Net operating loss for taxable year ending March 31, 1964, which could be carried back to taxable ending March 31, 1961.

In 1964 the taxpayer became an organization exempt from tax under Section 521, I.R.C. 1954, as contemplated in Section 1381(a)(1), and for that year under applicable tax laws it become entitled to deduct *both* capital stock dividends and patronage dividends from its gross earnings. Int. Rev. Code of 1954, Sections 1381(a)(1), 1382(b)(1), 1382(c)(1), and 1382(c)(2). Accordingly, in its return for that year, the taxpayer reported net earnings before dividends of $750,139.44, and deducted therefrom capital stock dividends paid during that year in the sum of $476,410.65 and patronage dividends in the sum of $430,013.00, thereby arriving at a claimed net operating loss of $156,284.21 for the year 1964. The taxpayer thereupon applied for and was allowed a tentative adjustment of its taxes for the fiscal year ending March 31, 1961, on account of the carryback of this claimed net operating loss for the fiscal year ending March 31, 1964. Subsequently, an examination of the taxpayer's return resulted in the Commissioner's reduction of the amount claimed by the taxpayer as a patronage dividend deduction by $223,660.36 for the year 1964 thus resulting in an elimination of the so-called net operating loss for 1964 and of the claimed carryback to 1961.

[APPENDIX]

In computing its patronage dividend for the year 1964, the taxpayer deducted from its net earnings, among other items, the sum of $245,112.50 *declared* as a capital stock dividend in 1964 but not paid in that taxable fiscal year. In computing its patronage dividends, the taxpayer ignored the fact that in 1964 it had actually paid a capital stock dividend of $476,410.65. By using the lesser sum, the taxpayer inflated the amount properly available for its patronage dividends and the corresponding deduction.

At the same time, however, the taxpayer, now being an exempt cooperative, deducted, as it had the right to do, its capital stock dividend, but in so doing deducted the sum of $476,410.65, which was the stock dividend paid in 1964. In other words, the taxpayer was attempting to have the best of two worlds, by using the lesser capital stock dividend figure in computing its patronage dividend figure, and thereby inflating its patronage dividend deduction, but using the greater dividend figure when deducting the capital stock dividend from its net earnings. It was the Commissioner's position that the taxpayer should use the same dividend-on-capital stock figures in both computations and urged that under the applicable statute, *see* Int.Rev.Code of 1954, Section 1388(a)(1), the proper figure is the one which represents the dividend actually *paid* in the year in issue. The tax court upheld that position, and we agree.

The language of Subchapter T, which was applicable to the taxpayer in 1964, as well as the regulations, would appear to require that in calculating a patronage dividend deduction, net earnings available for patronage dividends should first be reduced by the dividends *paid* on capital stock for the year in question. Int.Rev.Code of 1954, Section 1388(a); Treas.Reg., Section 1.1388-1 (1963). *See* Des Moines County Farm Service Company v. United States, *supra*.

III. Equitable Estoppel.

The taxpayer argues that the Commissioner is equitably estopped from asserting a deficiency for the year 1963 because the taxpayer's method of determining its patronage dividend by charging its capital stock dividend entirely to earnings derived from nonmember business had been used by the taxpayer from 1950 to and through 1962 and had never been questioned by the Commissioner, even though its returns had from time to time been audited. In this regard we agree with the tax court that the doctrine of equitable estoppel is inapplicable to the present controversy.

It is true that the doctrine of consistency or quasi-estoppel has on occasion been applied to prevent an injustice, but such has been done generally where there has been fraud or unfair conduct on the part of the Commissioner, with some degree of reliance thereon by the taxpayer to the latter's detriment. None of these aspects are present in the instant case.

And to the contrary, it is well established that the Commissioner is not estopped from challenging erroneously reported items where Internal Revenue agents have failed in prior years to challenge similarly erroneously reported items. Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); Massaglia v. Commissioner, 286 F.2d 258 (10th Cir. 1961); and Sanders v. Commissioner, 225 F.2d 629 (10th Cir. 1955). Language in the *Massaglia* case is particularly appropriate:

> "The very nature of government operations requires us to apply the principles of estoppel to its conduct with circumspection. * * * At the same time, we will not allow the government to deal dishonorably or capriciously with its citizens. It must not play an ignoble part or do a shabby thing. * * * 'The right and wrong of things and equitable principles have a place in tax matters.' Alamo National Bank v. Commissioner, 5

Cir., 95 F.2d 622. These standards of conduct may impose a duty of consistency on the government as well as the taxpayer. * * * But neither the duty of consistency, nor the principles of equitable estoppel bind the Commissioner to unauthorized acts of his agents * * * nor preclude him from correcting mistakes of law in the imposition and computation of tax liability, including the power to retroactively correct his rulings, regulations and decisions upon which taxpayers have relied. * * *" (Citations omitted.)

Accordingly, the decision of the tax court is affirmed.

APPENDIX "B"

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

MAY TERM
1973

UNION EQUITY COOPERATIVE EXCHANGE,
Petitioner-Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 72-1722

APPLICATION OF APPELLANT, UNION EQUITY, FOR A STAY OF MANDATE PENDING AN APPLICATION TO THE UNITED STATES SUPREME COURT FOR A WRIT OF CERTIORARI

COMES NOW The Petitioner-Appellant, Union Equity Cooperative Exchange, hereinafter referred to as Union Equity, and respectfully represents to the Court that heretofore, and on July 2, 1973, a judgment and decision was rendered adversely against it in the above entitled action.

THAT said action involved a very substantial tax assessment by the Commissioner of Internal Revenue, and

which resulted in an appeal in this Court from the Tax Court of the United States.

THAT heretofore, and on the 2nd day of July, an opinion was rendered by Circuit Judge McWilliams, after having been heard before former Circuit Judge Murrah, Judge Durfee, Judge of the Court of Claims, and Judge McWilliams, of the Circuit Court of Appeals; sitting as a panel for the Court.

THAT prior to the trial of this case, there had been two contradictory decisions rendered by the Circuit Courts of Appeals of the Eighth Circuit and Fifth Circuit respectively, to-wit:

Des Moines County Farm Service Company v. *U.S.*—324 Fed. Supp. Affirmed per curiam F. 2nd 776 (Eighth Circuit);

U.S. v. *Mississippi Chemical Company*—326 F. 2nd, 569, decided by the Fifth Circuit in 1964.

THAT your movant therefore deems it advisable and proper to file a Petition with the Supreme Court of the United States for a Writ of Certiorari to determine the conflict among the Circuits involved.

WHEREFORE, pursuant to Rule 41, of the Federal Rules of Appellate Procedure, Movant requests this Court to stay any mandate for a period of thirty days, in order that it may file its Petition with the Supreme Court.

DATED this 17th day of July, 1973.

s/ Frank Carter

t/ FRANK CARTER
ATTORNEY FOR MOVANT, UNION EQUITY COOPERATIVE EXCHANGE

STATE OF OKLAHOMA

ss:

COUNTY OF GARFIELD

Frank Carter, of lawful age, being first duly sworn on oath states that he has this day mailed a true and correct copy of the above and foregoing to the following parties of record in the above case, to-wit:

Ms. Carolyn R. Just, Scott P. Crampton, Esquire, Asst. Attorney General, and Meyer Rothwacks, Esquire, Tax Division, Dept. of Justice, Washington D.C., 20530

s/ Frank Carter

t/ FRANK CARTER

APPENDIX "C"

JULY TERM — JULY 27, 1973

Before Honorable Alfred P. Murrah, Senior Circuit Judge, Honorable James R. Durfee, Judge, Court of Claims, and Honorable Robert H. McWilliams, Circuit Judge

UNION EQUITY COOPERATIVE EXCHANGE,	)	
Petitioner-Appellant,	)	
v.	)	No. 72-1722
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent-Appellee.	)	

This matter comes on for consideration of appellant's application for a stay of mandate pending an application to the Supreme Court of the United States for a writ of certiorari.

Upon consideration whereof, it is ORDERED that the mandate is stayed until August 26, 1973, pending the timely filing by appellant of a petition for writ of certiorari in the Supreme Court of the United States. If, on or before that date, the Clerk of this Court shall receive notice from the Clerk of the Supreme Court of the United States that a timely petition for writ of certiorari has been filed in that Court, the stay of mandate shall continue until final disposition by the Supreme Court.

HOWARD K. PHILLIPS, Clerk
s/ By Robert L. Hoecker
t/ ROBERT L. HOECKER
Chief Deputy Clerk

CERTIFICATE OF SERVICE

Three true and correct copies of this petition for writ of certiorari have this day been mailed, postage prepaid, to:

Honorable Scott Crampton
Asst. Attorney General
Tax Division, Department of Justice
Washington, D. C. 20530

Department of Justice, Washington
Tax Division
Attn: Mrs. Carolyn Just
Washington, D. C. 20530

Mr. Howard K. Phillips, Clerk
United States District Court
Tenth Circuit
Denver, Colorado Mailed one copy

FRANK CARTER

LIBRARY
SUPREME COURT, U. S.

No. 73-374

FILED
OCT 19 1973

In the Supreme Court of the United States

OCTOBER TERM, 1973

UNION EQUITY COOPERATIVE EXCHANGE, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
SCOTT P. CRAMPTON,
Assistant Attorney General,
LEONARD J. HENZKE, JR.,
WILLIAM A. WHITLEDGE,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1973

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UNION EQUITY COOPERATIVE EXCHANGE, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A i-xii) is reported at 481 F. 2d 812. The findings of fact and opinion of the Tax Court (I-R. 47-48)[1] are reported at 58 T.C. 397.

JURISDICTION

The judgment of the court of appeals was entered on July 2, 1973. The petition for a writ of certiorari was filed on August 29, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, in computing the amount of the allowable patronage dividend deduction of a nonexempt

[1] "I-R." and "II-R." are references to Volumes I and II of the duplicated record in the court of appeals.

cooperative, the courts below properly determined that cash dividends paid on the capital stock must be ratably charged against earnings derived from both member and nonmember business.

STATEMENT

Petitioner is an Oklahoma cooperative marketing association incorporated and doing business pursuant to the Oklahoma Cooperative Marketing Association Act, 2 Okla. Stat. Ann. 361 *et seq.*, and the federal Act of February 18, 1922, 42 Stat. 388, 7 U.S.C. 291-292 (the Capper-Volstead Act). From 1950 through the year ended March 31, 1963, petitioner did not qualify as a tax exempt cooperative under Section 521 of the Internal Revenue Code of 1954 (I-R. 49, 50).

In accordance with its prior practice, petitioner decided that in March 1963 all net earnings from member business would be distributed as patronage dividends to the members, while net earnings from nonmember business would first be transferred to surplus and then be paid out as a five-percent capital stock dividend (I-R. 52-53). For the taxable year ending March 31, 1963, petitioner's total net earnings before adjustments for patronage dividends and dividends on capital stock were $1,519,884.69, of which 57.18 percent ($869,070.07) represented earnings from member business (Pet. App. A iv; I-R. 53). During this year, petitioner paid $439,674.44 in cash dividends on its capital stock (I-R. 62).

In calculating its patronage dividends for fiscal 1963, petitioner made certain insignificant reductions in the $869,070.07 earnings from member business and distributed $861,795.83 as patronage dividends (65 percent in cash and 35 percent in capital stock). It claimed such amount as a deductible patronage dividend. From its

total earnings from nonmember business (42.82 percent of $1,519,884.69), petitioner paid its taxes, transferred the balance to its general or surplus reserve, and, out of the latter, declared and paid a five-percent capital stock dividend (Pet. App. A v; I-R. 53, 60). Petitioner used this computational method since 1950 without challenge by the Internal Revenue Service during prior audits (Pet. App. A xi).

The Commissioner rejected petitioner's method of computing patronage dividends, and ruled that the cash dividend of $439,674.44 must first be subtracted from the total earnings of $1,519,884.69. The deductible patronage dividend would then equal 57.18 percent of the remaining $1,080,210.25, or $617,664.22 (I-R. 60, 62, 63). The Tax Court and the court of appeals upheld the Commissioner, ruling that his determination was in accord with the basic principle governing cooperatives that patronage dividends must be paid solely out of earnings from member business (Pet. App. A vi-viii; I-R. 64-68).

ARGUMENT

1. A cooperative corporation, like all enterprises, requires capital investment and must often pay dividends on its capital stock in order to compensate investors for their risks. Unlike normal corporations, however, cooperatives usually restrict such dividends to a fixed percentage or amount, so that they may maintain their true cooperative character by returning their profits as "patronage dividends" to their patrons. Such patronage dividends are usually returned to the cooperative's patrons in proportion to their dealings with the cooperative during the year. In computing taxable income a nonexempt cooperative such as petitioner may deduct amounts paid to member and nonmember patrons

alike, in that such amounts are treated as a rebate of the profit which is made on the particular patron's business.[2] In order to qualify as deductible patronage dividends, however, distributions to member patrons must be out of profits or income realized on transactions with members rather than nonmembers. *Pomeroy Cooperative Grain Co.* v. *Commissioner*, 288 F. 2d 326, 328 (C.A. 8).

---

[2]Prior to 1951, the deduction or exclusion of patronage dividends from the gross income of a cooperative was not recognized or sanctioned by any Internal Revenue Code provision. However, the deduction of patronage dividends by nonexempt cooperatives had long been permitted by administrative practice of the Treasury and the Internal Revenue Service. See, *e.g.*, *Des Moines County Farm Service Co.* v. *United States*, 324 F. Supp. 1216 (S.D. Iowa), affirmed *per curiam*, 448 F. 2d 776 (C.A. 8); *Clover Farm Stores Corp.* v. *Commissioner*, 17 T.C. 1265; *Farmers Cooperative Co.* v. *Birmingham*, 86 F. Supp. 201 (N.D. Iowa); *Puget Sound Plywood, Inc.* v. *Commissioner*, 44 T.C. 305; *Consumers Credit Rural Electric Cooperative Corp.* v. *Commissioner*, 37 T.C. 136, reversed and remanded, 319 F. 2d 475 (C.A. 6), on remand, 23 T.C.M. 149.

As early as 1918, the Treasury issued T.D. 2737, 20 Treasury Decisions, Internal Revenue 441, allowing the exclusion of patronage dividends paid by cooperatives to their patrons. The first statutory provision referring to this administrative practice appeared in the Revenue Act of 1951, 65 Stat. 452, Section 314(a). This Act added subparagraph (B) to Section 101 (12) of the 1939 Code (now Section 522(b) of the 1954 Code) to provide that patronage dividends for an *exempt* cooperative should "be taken into account in computing net income in the same manner as in the case of a cooperative organization not exempt."

The first statutory provisions explicitly permitting a nonexempt cooperative to deduct patronage dividends were contained in the Revenue Act of 1962, 76 Stat. 960, which added Sections 1381 through 1388 to the Internal Revenue Code (26 U.S.C.). However, these provisions apply only to taxable years beginning after December 31, 1962, and do not govern the taxable year ended March 31, 1963, which is at issue in this case.

As both courts below correctly held, petitioner's method of computing its patronage dividends deduction is not in accord with these basic principles governing cooperatives. By failing to deduct first the cash dividends from total cooperative earnings prior to allocating income between member and nonmember business, petitioner has charged the general expense of the cash dividend entirely against the earnings from nonmember business. This results in an artificially inflated figure for the earnings from member business and thereby produces a greater patronage dividend deduction. There is no warrant for such a method in either accounting or logic since the cash dividends were a proper charge against both member and nonmember earnings. As the court of appeals acknowledged in quoting with approval the statement of the Tax Court (Pet. App. A vii-viii; I-R. 67), this method incorrectly assumes that the "stockholders have invested only in those of petitioner's operations and assets which were used to transact nonmember business."

The Commissioner's method, which requires the initial reduction of cooperative earnings by the amount of any cash dividends paid on capital stock prior to a determination of the patronage dividend deduction, has the overwhelming and longstanding support of the authorities. *Producers Crop Improvement Ass'n* v. *Commissioner,* 7 T.C. 562; *Valparaiso Grain & Lumber Co.* v. *Commissioner,* 44 B.T.A. 125; *Farmers Union Cooperative Exchange* v. *Commissioner,* 42 B.T.A. 1200, appeal dismissed, 122 F. 2d 718 (C.A. 10); *Trego County Cooperative Ass'n* v. *Commissioner,* 6 B.T.A. 1275; *Des Moines County Farm Service Co.* v. *United States,* 324 F. Supp. 1216 (S.D. Iowa), affirmed *per curiam,* 448 F. 2d 776 (C.A. 8). Moreover, after many of

the judicially and administratively created principles governing cooperatives were added to the Code in 1962, the Commissioner's computational method was specifically adopted in Section 1.1388-1(a) of the Treasury Regulations and this aspect of the regulation has been upheld. *Des Moines County Farm Service Co.* v. *United States, supra.*

2. Contrary to petitioner's contention (Pet. 7-10), there is no conflict between the decision below or the Eighth Circuit's *Des Moines County* decision and that of the Fifth Circuit in *United States* v. *Mississippi Chemical Co.* 326 F. 2d 569, which warrants review by this Court. In *Mississippi Chemical,* the district court (197 F. Supp. 490) found as a fact that a computation similar to that urged by petitioner did not result in a diversion of profits from nonmember business to member business profits eligible for patronage dividends because the cooperative's by-laws permitted such an allocation. The Fifth Circuit affirmed on the ground that this finding was "particularly correct." Here, however, both courts below declined to make such a finding with respect to petitioner's total claimed patronage dividend deductions.

Moreover, while we disagree with the factual determination made in *Mississippi Chemical,* that case did not announce any legal principle contrary to that set forth either by the Tenth Circuit below or by the Eighth Circuit in *Des Moines County.* Significantly, the basis of the *Des Moines County* opinion was its approval of Section 1.1388-1(a) of the Treasury Regulations as a valid and reasonable construction of the statute. This Regulation, which was promulgated after the district court's decision in *Mississippi Chemical* and which was not considered by the Fifth Circuit, is in accord with the

decision below. In the light of these subsequent developments, it is by no means certain that petitioner would prevail had its case been presented to the Fifth Circuit. Thus, to the extent that *Mississippi Chemical* is deemed to represent a variant approach, its current validity is dubious.

3. Finally, petitioner erroneously asserts (Pet. 10) that the Commissioner's failure to challenge its method of computing patronage dividends in the prior 19 years equitably estops him with respect to the taxable year in question. It is well established that the Commissioner is not estopped from challenging erroneously reported items where Internal Revenue Service agents have failed in prior taxable years to challenge similarly erroneously reported items. *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180; *Sanders* v. *Commissioner*, 225 F. 2d 629 (C.A. 10), certiorari denied, 350 U.S. 967; *Tollefsen* v. *Commissioner*, 431 F. 2d 511 (C.A. 2), certiorari denied, 401 U.S. 908.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

SCOTT P. CRAMPTON,
Assistant Attorney General.

LEONARD J. HENZKE, JR.,
WILLIAM A. WHITLEDGE,
Attorneys.

OCTOBER 1973.

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Supreme Court, U. S.
FILED
OCT 25 1973
MICHAEL RODAK, JR., CLERK

In the

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1973

No. 73-374

UNION EQUITY COOPERATIVE EXCHANGE INC.,
Petitioner,

VERSUS

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Appendix "D"

FRANK CARTER
1010 Bass Building
Enid, Oklahoma 73701

Counsel for Petitioner

of Counsel:

CARTER & CARTER
Bass Building
Enid, Oklahoma 73701

August, 1973

UTTERBACK TYPESETTING CO., 519 W. CALIF., OKLAHOMA CITY, PH. 235-0030

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Appendix D:

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58 T. C. No. 41

UNITED STATES TAX COURT

UNION EQUITY COOPERATIVE EXCHANGE, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 439-70. Filed May 31, 1972.

Petitioner was a nonexempt cooperative in its taxable year 1963 and an exempt cooperative in its taxable year 1964. In each year petitioner distributed a patronage dividend to its patrons and a dividend on capital stock to its stockholders.

Held: (1) In its taxable year 1963 petitioner could not charge the dividend on capital stock solely to nonmember earnings, but had to charge such dividend to net earnings realized from member business and to net earnings realized from nonmember business in proportion to the business transacted with members and nonmembers respectively. (2) Respondent was not estopped from determining a deficiency for the taxable year 1963 simply because in prior years he had failed to make such determination with respect to petitioner's method of accounting for dividends on capital stock. (3) In the taxable year 1964 petitioner did not sustain a net operating loss which could be carried back to the taxable year 1961. Petitioner's claimed patronage dividend deduction for 1964 was overstated because petitioner had reduced net earnings by the dividend *declared* on capital stock (instead of by the dividend actually *paid* on capital stock) before computing its patronage dividend. Furthermore, respondent's approval of a tentative carryback adjustment of petitioner's 1961 tax did not preclude his later determination, by way of a deficiency notice in the

usual manner, that the adjustment should not have been allowed.

Frank Carter, for the petitioner.

Thomas J. Miller, for the respondent.

OPINION

FORRESTER, *Judge:* Respondent has determined deficiencies in petitioner's income tax of $81,267.77 and $138,-164.30 for the taxable years 1961 and 1963, respectively. Petitioner does not contest certain of the adjustments which respondent has made in petitioner's taxable income for the taxable year 1963. The questions we must resolve are: (1) whether for the taxable year 1963 petitioner may charge dividends on its capital stock solely to net earnings arising from its nonmember business; (2) whether because of his inaction with respect to prior taxable years, respondent is now equitably estopped from attacking petitioner's method of accounting for such dividends; and (3) whether for the taxable year 1964 petitioner is entitled to a net operating loss which would have the effect of reducing its income tax liability for the taxable year 1961.

All of the facts have been stipulated and are so found. The stipulation and attached exhibits are incorporated herein by this reference.

Petitioner is an Oklahoma cooperative marketing association incorporated and doing business pursuant to the Oklahoma Cooperative Marketing Association Act, Okla. Stat. Tit. 2, sec. 361 et seq. (West 1964), and the Capper-Volstead Act, 7 U.S.C. secs. 291-292 (1970). At the time of the filing of the petition herein petitioner's principal office was in Enid, Oklahoma. Petitioner filed Federal income tax returns for its taxable years 1961 and 1963 with the district director of internal revenue in Oklahoma City, Oklahoma.

For all taxable years relevant to this case petitioner's taxable year ended on March 31.

Petitioner was authorized to issue $20,000,000 of capital stock consisting of 40,000 shares having a par value of $500 each and such stock could not be sold for less than its par value. According to its by laws, any local farmers' cooperative elevator association which was eligible for membership in petitioner and which owned one or more shares of petitioner's capital stock was deemed to be a member of petitioner. Eligibility for membership and for ownership of stock in petitioner were restricted as follows:

> Any local farmers' cooperative elevator association organized and operating in conformity with the provisions of the Capper-Volstead Act and located in any territory served by this Association, may become a member of this Association upon written application accepted by the Board of Directors, by agreeing to comply with, and become subject to, all the requirements and provisions of these By-Laws and by purchasing at least one share of its capital stock. Only such local farmers' cooperative elevator associations shall be or remain eligible to hold stock or participate in the affairs and management of this Association.

Petitioner declared and paid dividends on its capital stock as follows:

Amount	*Declared*	*Paid*
$439,674.44	March 1962	May 1962
476,410.65	March 1963	May 1963
245,112.50	February 1964	May 1964
249,275.00	March 1965	May 1965

From 1950 through its taxable year 1963, petitioner was a nonexempt farmers' cooperative. On May 8, 1962, petitioner adopted bylaws which were in effect for the taxable year 1963 and which provided in pertinent part as follows:

ARTICLE VIII

Apportionment of Earnings

Section 1. The Directors, subject to revision by the members at the regular or special meeting lawfully called, shall apportion the net earnings at least once in each year.

Section 2. The net earnings accrued on business transacted with or for non-members shall be apportioned as follows:

(A) For payment of income taxes on the amount of such net earnings.

(B) The remaining net earnings or any portion thereof may be used to pay dividends on the membership capital or stock at a rate not to exceed five percent (5%) per annum.

(C) The remainder of the net earnings may be transferred to the Surplus Reserve Fund for the purpose of building the Surplus Reserve Fund to meet the requirements of state law and/or liquidate incurred indebtedness or provide needed working capital, or to provide such additional reserves as may be reasonable and necessary; or

(D) The remainder of the net earnings may be apportioned and distributed ratably on the basis of patronage, and in the same media, as provided for in Section 3 of this Article.

Section 3. The net earnings accrued on business transacted with or for members of cooperative organizations who are eligible and approved for membership, shall be apportioned as follows:

(A) If the portion of the net earnings on nonmember business which was transferred to the Surplus Reserve Fund, as provided for in Section 2 of this Article, does not equal ten percent (10%) of the total net earnings for the fiscal year, then an amount equal to the

difference between the amount so transferred from earnings on non-member business, and ten percent (10%) of the total net earnings for the fiscal year, shall be set aside in the Surplus Reserve Fund until such reserve fund shall equal the amount of the paid-up Capital Stock.

(B) If the net earnings on non-member business is not sufficient to pay dividends on the membership Capital, or Stock, as provided for in Section 2 of this Article, then dividends at a rate not to exceed five percent (5%) per annum may be paid from the net earnings accrued on business done with or for members or cooperative organizations who are eligible and approved for membership.

(C) If the net earnings on non-member business is not sufficient to pay the income tax for the fiscal year by reason of apportionment of member earnings as provided under (A) and/or (B) above, the balance of the income tax shall be paid from the net earnings accrued on business done with or for members or cooperative organizations who are eligible and approved for membership.

(D) The remainder of the total net earnings shall be apportioned and distributed ratably upon amounts charged for services and upon the value or volume of the products sold to, or handled through, the Association and/or the value or volume of the purchases from, or through, the Association, to all members and cooperative organizations, who are eligible and approved for membership, on the same basis and same percentage. Such earnings shall be distributed either in cash, capital stock, allocated or Special Reserves, provided that amounts prorated to cooperative organizations who are not members but are eligible and have been approved for membership shall be distributed to them in credits on Capital Stock until such accumulated credits are sufficient to cause a share of stock to

be issued as provided for in Article I, Section 2, of these By-Laws.

(E) An amount not less than thirty-five percent (35%) of each members [sic] patronage apportioned under this Section shall be credited to the purchase of additional Capital Stock until such member owns fifty (50) fully paid shares.

During a meeting of petitioner's directors on March 18-19, 1963, a motion was made and carried approving the distribution of petitioner's net earnings for the taxable year 1963 as follows:

1. Net Earnings derived from member business be distributed on the basis of patronage—65% shall be payable in Cash and 35% shall be in Capital Stock.
2. Net Earnings from non-member business be transferred to surplus, and
3. 5% Dividend on outstanding stock be paid out of surplus.

For the taxable year 1963 petitioner's total net earnings before adjustments for patronage dividends and dividends on capital stock were $1,519,884.69. In that taxable year petitioner's member business constituted 57.18 percent of the total business it conducted. In calculating the distribution of its net earnings for the taxable year 1963 petitioner first determined that its members had generated $869,070.07 (57.18 percent of $1,519,884.69) of its net earnings. From this sum it made certain reductions and distributed as patronage dividends to its members $559,254.53 in cash and $302,541.30 in capital stock. It paid income tax from the balance of its net earnings and transferred the remaining net earnings to its general or surplus reserve.

From 1950 through the taxable year 1962 petitioner followed its bylaws and charged the dividends it paid on

capital stock first to nonmember earnings before computing its patronage dividend deduction. During these years the Internal Revenue Service made periodic audits of petitioner's tax returns, but the examining agents never questioned this accounting practice.

For its taxable year 1964 petitioner was an organization exempt from tax under section 521.[1] On May 14, 1963, petitioner adopted bylaws which were in effect for the taxable year 1964 and which provided in pertinent part as follows:

ARTICLE VIII

Apportionment of Earnings

Section 1. APPORTIONMENT. The directors, subject to revision by the members at the regular or special meeting lawfully called, shall apportion the net earnings at least once in each year.

Section 2. LEGAL RESERVE. Ten percent (10%) of the total net earnings for the fiscal year shall be apportioned and set aside to the general reserve fund unless and until such reserve fund shall equal the amount of the paid-in-capital stock.

Section 3. STOCK DIVIDENDS. A dividend not to exceed five percent (5%) may be paid to the stockholders computed on the par value of the capital stock held by each stockholder.

Section 4. PATRONAGE DISTRIBUTION. The remainder of the net earnings shall be apportioned, allocated, and distributed ratably on the basis of patronage to both members and non-members alike (except to the United States Government or any of its agencies), and shall be based upon the value or quantity of the products sold to or handled through this Association.

[1] Unless otherwise specified, all statutory references are to the Internal Revenue Code of 1954.

Such earnings shall be distributed either in cash, capital stock, allocated or special reserves; provided, that not less than twenty percent (20%) of the amount of such patronage dividend shall be paid in money, or qualified check; and, provided further, that amounts pro rated to cooperative organizations who are not members but are eligible and have been approved for membership shall be distributed to them in credits on capital stock until such accumulating credits are sufficient to cause a share of stock to be issued as provided for in Article I, Section 2, of these By-Laws.

Section 5. STOCK BUILD-UP REQUIREMENTS. An amount not less than thirty-five percent (35%) of each members patronage apportioned under this Section shall be credited to the purchase of additional capital stock until such member owns fifty (50) fully paid shares.

During the meeting of petitioner's directors on February 23-24, 1964, a motion was made and carried approving the distribution of petitioner's net earnings for the taxable year 1964 as follows:

That 10% of the Net Earnings be transferred to General Reserve;

A stock dividend of 2 1/2% be paid on all outstanding paid up stock; and the remainder of Net Earnings shall be distributed ratably on the basis of patronage to members and non-members—50% in Cash and 50% in Capital Stock.

For the taxable year 1964 petitioner filed an "Exempt Cooperative Association Income Tax Return" (Form 990-C). On that return petitioner reported total income of $3,132,989.25 and total deductions and adjustments of $3,289,273.46 to arrive at a net operating loss of $156,284.21. Of the deductions and adjustments a total of $906,423.65 constituted deductions or adjustments which petitioner

calculated under section 1382 and which it further broke down as follows:

Dividend paid on capital stock	$476,410.65
Patronage dividends: money	216,978.86
Patronage dividends: Qualified written notices of allocation	213,034.14
Total	$906,423.65

Petitioner sought to carry back its claimed net operating loss for the taxable year 1964 to the taxable year 1961. As a result it filed an "Application for Tentative Carryback Adjustment" (Form 1139, Rev. June 1961) dated June 12, 1964, in which it applied for a tentative carryback adjustment under section 6411. On that application petitioner computed that its income tax for the taxable year 1961 should have been decreased by $81,267.77 as a consequence of carrying the claimed net operating loss of $156,284.21 for the taxable year 1964 back to the taxable year 1961. In a "Notice of Allowance of Tentative Carryback Adjustment" (Form 7780-B) dated October 26, 1964, the Internal Revenue Service notified petitioner that it had approved petitioner's "Application for Tentative Carryback Adjustment." The Internal Revenue Service allowed petitioner the tentative carryback adjustment of $81,267.77 plus interest to October 26, 1964, of $2,772.

There are three principal issues presented for our consideration.

1. *Patronage Dividend Allowable for the Taxable Year 1963.*

During the taxable year 1963 petitioner was a nonexempt cooperative marketing association incorporated under the laws of Oklahoma. Petitioner's stockholders were its members and only its members were eligible to hold its stock.

As in effect for that year, the Internal Revenue Code of 1954 had no specific provisions dealing with the taxation of nonexempt cooperative organizations. However, since at least 1918, respondent had consistently ruled that, under proper circumstances, a nonexempt cooperative could deduct or exclude from gross income certain amounts qualifying as refunds or dividends paid on the basis of patronage. T.D. 2737, 20 Treas. Dec. Int. Rev. 441 (1918); see also *Puget Sound Plywood, Inc.*, 44 T.C. 305, 318 (1965) and rulings cited therein; cf. T.D. 1946, 16 Treas. Dec. Int. Rev. 100 (1914). The courts have recognized and given sanction to those rulings so that there now exists a relatively large body of case law delineating with some particularity the conditions under which nonexempt cooperatives operating before the effective date of subchapter T[2] might qualify certain distributions as patronage dividends. *Puget Sound Plywood, Inc., supra* at 318-319 and cases cited. For the sake of simplicity and in accordance with the terminology now employed in subchapter T, we shall speak of such qualified distributions as deductions.[3]

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[2] Subchapter T, secs. 1381-1388, which now controls the taxation of both exempt and nonexempt cooperative organizations is effective only for taxable years beginning after December 31, 1962. Sec. 17(c)(1), Revenue Act of 1962, 76 Stat. 960, 1051; *Petaluma Co-Operative Creamery*, 52 T.C. 457, 465, fn. 3 (1969). Petitioner's taxable year 1963 began on April 1, 1962, just nine months before the effective date of subchapter T.

[3] See sec. 1382(b). In the government's earlier rulings patronage dividends seemed to have been treated as deductions from gross income. E.g., I.T. 1499, I-2 C.B. 189 (1922). But the later rulings treated amounts distributed as patronage dividends as exclusions from gross income. See G.C.M. 17895, 1937-1 C.B. 56; see also Rev. Rul. 59-107, 1959-1 C.B. 20; Rev. Rul. 57-59, 1957-1 C.B. 24; Rev. Rul. 54-10, 1954-1 C.B. 24; I.T. 3208, 1938-2 C.B. 127. Our use of the term "deduction" should not be interpreted as a determination that patronage dividends should be treated as deductions for other purposes of the Internal Revenue Code. See sec. 1.1382-1(a), Income Tax Regs. We note that at least one court has held that the enactment of subchapter T has not changed the character of patronage dividends and that amounts so distributed should be considered to be exclusions from gross income.

Before analyzing the facts in the instant case it would be helpful to set forth the basic principles under which an allocation of a cooperative's earnings may qualify as a true patronage dividend. As we recently stated in *Petaluma Co-Operative Creamery*, 52 T.C. 457, 465-466 (1969):[4]

> An allocation of earnings by a cooperative to its patrons will not qualify as a true patronage dividend unless three requirements are met. The first one is that the allocation must be made pursuant to a legal obligation which existed at the time the participating patrons transacted their business with the cooperative. The second requirement is that the allocation must be made out of profits or income realized from transactions with the particular patrons for whose benefit the allocation was made. The third requirement is that the allocation of earnings must be made ratably to the particular patrons whose patronage created the income from which the allocated refund was made. * * *

See also, e.g., *Smith & Wiggins Gin, Inc.* v. *Commissioner*, 341 F. 2d 341, 350 (C.A. 5, 1965), affirming 37 T.C. 861 (1962); *United States* v. *Mississippi Chemical Company*, 326 F. 2d 569, 573-574 (C.A. 5, 1964); *Farmers Cooperative Co.*, 33 T.C. 266, 268 (1959), reversed on other grounds 288 F. 2d 315 (C.A. 8, 1961); *Linnton Plywood Association* v.

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[3] (Continued)
Mississippi Valley Portland Cement Co. v. *United States*, 408 F. 2d 827, 831, fn. (C.A. 5, 1969), certiorari denied 395 U.S. 944 (1969).

[4] The term patronage dividend is now statutorily defined. See sec. 1388 (a) quoted at fn. 15, *infra*. It has been stated that with "respect to the definition of a patronage distribution, however, sections 1381 et seq. are merely a codification of prior case law." *Mississippi Valley Portland Cement Co.* v. *United States*, 408 F. 2d 827, 831, fn. 7 (C.A. 5, 1969), certiorari denied 395 U.S. 944 (1969). But see *Certified Grocers of Florida, Inc.* v. *United States*, an unreported case (M.D. Fla. 1966, 18 A.F.T.R. 2d 5012, 66-2 U.S.T.C. par. 9493) comparing the statutory provisions of subchapter T with the older judicially evolved law as stated in *Farmers Cooperative Company* v. *Commissioner*, 288 F. 2d 315 (C.A. 8, 1961), reversing 33 T.C. 266(1959).

United States, 236 F. Supp. 227, 228 (D. Ore. 1964); *Farmers Cooperative Co.* v. *Birmingham*, 86 F. Supp. 201, 230 (N.D. Iowa 1949).

In the taxable year 1963 petitioner had net earnings of $1,519,884.69 of which 57.18 percent (or $869,070.07) had been generated by petitioner's members. After slightly reducing this sum of $869,070.07 for reasons which are not apparent from the record, petitioner distributed to its members as a patronage dividend $861,795.83 in cash and in its stock. From the remainder of its net earnings petitioner paid income tax and subtracted $476,410.65 which it had declared in the taxable year 1963 as a five-percent dividend on its capital stock, but which it did not pay until the taxable year 1964. Petitioner transferred what then remained of its net earnings to its general or surplus reserve.

Respondent points out that petitioner's method of computing its patronage dividend has the effect of charging the dividend on capital stock solely to earnings generated by nonmember business. He states that, "By charging capital stock dividends only to income generated by business done with nonmember patrons, rather than ratably against total income, petitioner's net earnings from business done with member patrons is overstated." Respondent would reject petitioner's method of accounting and instead would rely on the accounting method described in A.R.R. 6967, III-1 C.B. 287,. 289 (1924),[5] restated and superseded by Rev. Rul. 68-228, 1968-1 C.B. 385.

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[5] In pertinent part A.R.R. 6967 provides as follows:

> First compute the apparent net income of the cooperative association. From this amount deduct the fixed dividend paid or payable on any outstanding capital stock. The amount of such fixed dividend is the portion of net income properly attributable to the investment made in the association by the holders of any capital stock.
>
> The balance consists of (1) the amount available for refund to the members of the association and (2) the profits made from nonmembers. In the absence of evidence to the contrary, it will be assumed that

Under that ruling respondent would first subtract from petitioner's net earnings of $1,519,884.69 the dividend on capital stock actually paid in the taxable year 1963, $439,674.44.[6] The balance remaining would consist of (1) the amount available for a patronage dividend to petitioner's members and (2) the profits made from nonmembers. In the absence of evidence to the contrary, respondent would assume that petitioner's dealings with members and nonmembers were equally profitable, and, accordingly, that

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[5] (Continued)
the dealings with members and nonmembers are equally profitable, and, accordingly, that the amount available for refund consists of that proportion of the apparent net profits, after deducting the fixed dividend on outstanding capital stock, which the amount of business transacted with members bears to the entire amount of business transacted. Up to the amount available for refund thus computed, a distribution by a cooperative association to its members, upon the basis of the business transacted with them, will be deemed to be a true patronage dividend, deductible by the association in computing its taxable net income for Federal income and profits tax purposes.

[6] In its calculations petitioner has used the figure $476,410.65 which represents the dividend on capital stock declared in the taxable year 1963 but not paid until the taxable year 1964. We note that respondents use of the figure $439,674.44 (which was the dividend on capital stock actually paid in the taxable year 1963) is more favorable to petitioner in that it results in a larger allowable patronage dividend under the rule of A.R.R. 6967. Consequently we express no opinion on the question of which of the two figures is the proper one for calculating petitioner's allowable patronage dividend. For the same reason we do not deem it necessary to decide whether the apportionment here falls within the rule set forth in *Producers Crop Improvement Association*, 7 T.C. 562, 567 (1946) which held that, under the particular facts there, dividends declared on preferred stock during the taxable year accrued in that same year, become a debt in that year, and hence served to reduce that year's net earnings available for patronage dividends. However, we should point out that in determining the respective amounts satisfying each of the three requirements set out in *Petaluma Co-Operative Creamery, supra* (or in satisfying each of the three basic statutory requirements now listed in sec. 1388 (a)), the dividend *declared* in the taxable year may be crucial in determining the amount satisfying one requirement while in satisfying another requirement the dividend actually *paid* in the taxable year may be the proper measure of the amount available.

the amount available for a patronage dividend to members consisted of that proportion (57.18 percent) of the net earnings (after deducting the dividend on capital stock) which the amount of business transacted with members bore to the entire amount of business transacted. Following through with these computations, respondent has disallowed over $200,000 which petitioner had claimed as a patronage dividend.

The accounting method set forth in A.R.R. 6967 has been used in *Producers Crop Improvement Association,* 7 T.C. 562 (1946); *Farmers Union Cooperative Exchange,* 42 B.T.A. 1200 (1940); and *The Trego County Cooperative Association,* 6 B.T.A. 1275 (1927), upon the apparent mutual agreement of the parties therein. In *Valparaiso Grain & Lumber Co.,* 44 B.T.A. 125, 127 (1941), where the taxpayer computed its patronage dividend in the same manner as petitioner here, it was held that the computation rule of A.R.R. 6967 was "fair and reasonable and its use is accordingly sustained." In light of the record in the instant case we must also sustain the use of A.R.R. 6967 as being more than fair and eminently reasonable.

It is true that A.R.R. 6967 is but an administratively formulated rule by which the allowable patronage dividend may be computed. In discussing the applicability of A.R.R. 6967, the Fifth Circuit stated in *United States* v. *Mississippi Chemical Company,* 326 F. 2d 569, 575 (C.A. 5, 1964), that:

> As a matter of fact and law, administrative practice has no effect upon the determination of what constitutes gross income, except insofar as the practice is in accord with the rules of law governing that determination.

Therefore, in order to justify the applicability of A.R.R. 6967 in this case, it is necessary to show that its operation reflects and incorporates those principles which underlie the definition of a true patronage dividend.

An amount distributed by petitioner would qualify as a true patronage dividend only to the extent that it satisfied each of the three requirements set out in *Petaluma Co-Operative Creamery* (52 T.C. 457, 465-466 (1969)). In effect this means that if any of the amounts satisfying each of the respective requirements are different from each other, only the smallest such amount may be looked to in arriving at the allowable patronage dividend. We find that at least to the extent that it exceeds respondent's allowed patronage dividend deduction, petitioner's claimed patronage dividend deduction fails to satisfy the requirement that it "be made out of profits or income realized from transactions with the particular patrons for whose benefit the allocation was made." *Petaluma Co-Operative Creamery, supra* at 466.

Petitioner derived net earnings of $1,519,884.69 from transactions between itself and both member patrons and nonmember patrons. In the absence of any proof that nonmember's business was more or less profitable than member business respondent's determination that the profits derived from either business was in direct proportion to the amount of such business is indeed reasonable.[7] Petitioner does not reject this aspect of respondent's determination. But it does an immediate turnabout with respect to that practical rule by urging, in effect, that the dividend on

[7] Without the practical rule of apportionment of member and nonmember profits in accordance with member and nonmember business as set forth in A.R.R. 6967, it would not be inconceivable for respondent to claim that petitioner's profits derived exclusively from nonmember business. Thus, respondent might have determined that none of the amounts which petitioner paid out as a patronage dividend to its members was a true patronage dividend. Since the burden would be on petitioner to show that respondent's determination was erroneous, Rule 32, Tax Court Rules of Practice, petitioner might then be put to the very difficult proof of the respective profitableness of member and nonmember business. It is interesting that at least one taxpayer has used the presumptive rule of A.R.R. 6967 to its favor by showing that one aspect of its nonmember business resulted in no profit at all. *Producers Crop Improvement Association*, 7 T.C. 562 (1946).

capital stock should be charged and attributable only to earnings from nonmember business.

Such attribution ignores the dual nature of the stockholder-patron's interest in its nonexempt cooperative.

On the one hand the stockholder-patron receives a distribution from its cooperative solely in respect of its status as stockholder. This is a normal dividend from net earnings which is not deductible at the cooperative level in the same manner that a distribution of earnings and profits by an ordinary corporation is not deductible at the corporate level.[8] The distributions are based on the stockholder's investment in the cooperative and represent a return on that investment—the greater the investment, the greater the dividend on capital stock.

On the other hand, the stockholder-patron also receives a distribution solely in respect of its status as patron. This latter distribution is based on its patronage with the cooperative during the year—the greater the patronage, the greater the patronage dividend.

In attributing the entire dividend paid on capital stock to nonmember business, petitioner is saying, in effect, that

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[8] It was early recognized that a dividend paid on the capital stock of a nonexempt cooperative was not deductible or excludable and had, in fact, the same character as a dividend paid upon the stock of the usual non-cooperative corporation. E.g., *Cloquet Cooperative Society*, 21 B.T.A. 744 (1930); *Riverdale Co-operative Creamery Association*, 18 B.T.A. 1159 (1930), affd. 48 F.2d 711 (C.A. 9, 1931); *The Trego County Cooperative Association*, 6 B.T.A. 1275 (1927); *Farmers Co-operative Association*, 5 B.T.A. 61 (1926); *Sacred Heart Cooperative Mercantile Co.*, 2 B.T.A. 24 (1925); S.M. 2595, III-2 C.B. 238 (1924), declared obsolete by Rev. Rul. 70-319, 1970-1 C.B. 284. Only an exempt cooperative could then, or can now, claim special deductions for such a dividend and then only to an extent that would not jeopardize its exemption. See, e.g., secs. 521(b)(2) and 1382(c)(1); *South Carolina Produce Ass'n* v. *Commissioner*, 50 F.2d 742 (C.A. 4, 1931), affirming 19 B.T.A. 1028 (1930); *Farmers Mutual Cooperative Creamery*, 33 B.T.A. 117 (1935); *Laura Farmers Cooperative Elevator Co.* v. *United States*, 273 F. Supp. 1019 (S.D. Ill. 1967).

its stockholders have invested only in those of petitioner's operations and assets which were used to transact nonmember business. See *Des Moines County Farm Service Co.* v. *United States*, 324 F. Supp. 1216, 1220 (S.D. Iowa 971), affd. 448 F.2d 776 (C.A. 8, 1971); cf. *Fertile Co-operative Dairy Ass'n* v. *Huston*, 119 F.2d 274, 277-278 (C.A. 8, 1941). We are unable to find any indication that the stockholders here invested in anything but the undivided totality of petitioner's operations and assets. By following a computational path that fails to reflect the reality underlying its mode of operation, petitioner has substituted accounting fiction for taxable fact.

Consequently, in the absence of any evidence to the contrary, we uphold respondent's determination that the dividend paid on petitioner's capital stock was properly attributable to net earnings realized from member business and to net earnings realized from nonmember business in proportion to the business transacted with members and nonmembers respectively. Conversely, the amount of member earnings available for distribution as a true patronage dividend would have to be reduced by that part of the dividend on capital stock which was attributable to member earnings.

Petitioner places almost complete reliance on *United States* v. *Mississippi Chemical Company*, 326 F.2d 569 (C.A. 5, 1964), affirming 197 F. Supp. 490 (S.D. Miss. 1961). Unfortunately for petitioner that case is distinguishable.

In reaching its decision in that case the district court found as a fact incorporated into its conclusions of law that no part of the sum paid as patronage dividends was paid from the profits on nonstockholder business. 197 F. Supp. at 492. In affirming the district court, the Court of Appeals for the Fifth Circuit stated that this finding was "particu-

larly correct."[9] 326 F.2d at 574. Here, we have not and could not make the factual finding which underlay the decision in *Mississippi Chemical*.[10] To the contrary, we have necessarily found that part of the sum which petitioner called a patronage dividend was in fact attributable to profits from nonstockholder business.

2. *Equitable Estoppel*

The parties have stipulated that from 1950 through the taxable year 1962 petitioner charged its dividends on capital stock to nonmember earnings and that for those years respondent's agents never questioned this accounting practice. On the basis of this stipulation petitioner argues that it has relied on its accounting method for so many years that it would be inequitable to force petitioner to adopt the accounting method which respondent urges in this case.

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[9] The district court also found that—

> plaintiff's charter contains a contractual provision whereby the common stock dividends are to be paid first from profits on non-stockholder business and only the deficiency, if any, may be deducted from the margins on stockholder patronage. [197 F.Supp. at 491]

The Fifth Circuit placed great emphasis on the view that the charter's provisions prevented the disputed amounts from becoming a part of the cooperative's gross income. In the Fifth Circuit's view, respondent had no legal right, by using A.R.R. 6967, "to transform income of the patrons into income taxable to the cooperative." 326 F.2d at 574. We remark that under factual circumstances substantially similar to those in *Mississippi Chemical*, the Eighth Circuit has held that under the provisions of subchapter T and the regulations thereunder, a cooperative's bylaws will in effect be disregarded for Federal income tax purposes where they conflict with valid statutory and regulatory requirements. *Des Moines County Farm Service Co.* v. *United States*, 448 F.2d 776 (C.A. 8, 1971), affirming 324 F. Supp. 1216 (S.D. Iowa 1971).

[10] An indication that *United States* v. *Mississippi Chemical Company*, 326 F.2d 569 (C.A. 5, 1964), must be strictly limited to the particular facts therein may be found in the Fifth Circuit's later recognition that its prior opinion "begins with the assumption that the distributions to shareholders were bona fide patronage dividends." *Mississippi Valley Portland Cement Co.* v. *United States*, 408 F.2d 827, 835 (C.A. 5, 1969).

The short and complete answer to petitioner's plea is that it is well established that the Commissioner is not estopped from challenging erroneously reported items where its agents have failed, in prior taxable years, to challenge similar erroneously reported items. E.g., *Fidelity Commercial Co.*, 55 T.C. 483, 490 (1970), affd. (C.A. 4, 1971, 28 A.F.T.R.2d 5751, 71-2 U.S.T.C. par. 9667); *David O. Rose*, 55 T.C. 28, 32 (1970); *Lozoff* v. *United States*, 266 F. Supp. 966, 971 (E.D. Wis. 1967), affd. 392 F.2d 875 (C.A. 7, 1968). The mere fact that petitioners may have obtained a windfall in prior years does not entitle it to like treatment for the taxable year here in issue. *George R. Tollefson*, 52 T.C. 671, 681 (1969), affd. 431 F.2d 511 (C.A. 2, 1970), certiorari denied 401 U.S. 908 (1971).

3. *Net Operating Loss Allowable for the Taxable Year 1964*

Respondent determined a deficiency in petitioner's income tax for the taxable year 1961 on the ground that it did not sustain a net operating loss in the taxable year 1964, and therefore was not entitled to a net operating loss carryback from the taxable year 1964 to the taxable year 1961.

For the taxable year 1964 petitioner was an "organization exempt from tax under section 521" as contemplated in section 1381(a)(1). However, an "organization exempt from tax under section 521" is not necessarily exempt from all income taxes.[11] Section 1381(b) states that "An organi-

[11] In the Revenue Act of 1951 Congress changed sec. 101(12) of the 1939 Code so that cooperatives which had been totally exempt from income taxes became subject to the regular corporate income tax at least to the extent of certain earnings placed in reserve and not allocated to patrons. S. Rept. No. 781, 82d Cong., 1st Sess. (1951), 1951-2 C.B. 458, 472. The reason for this change was stated in S. Rept. No. 781, 82d Cong., 1st Sess. (1951), 1951-2 C.B. 458, 473, as follows:

> As a result of this action, all earnings or net margins of cooperatives will be taxable either to the cooperative, its patrons or its stock-

zation described in subsection (a)(1) shall be subject to the taxes imposed by section 11 or 1201."

The crucial difference between the taxation of a corporation operated on a cooperative basis and the taxation of the usual corporation is that a cooperative must employ the special rules of section 1382 in computing its taxable income for the purposes of section 11 or section 1201. Sec. 1.1381-2(a)(1), Income Tax Regs. There is also a distinction between the treatment of a nonexempt cooperative and the treatment of an organization exempt from tax under section 521(a). While a nonexempt cooperative is entitled only to the extra "deductions"[12] allowed by section

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[11] (Continued)
holders with the exception of amounts which are paid or allocated to patrons on the basis of purchases of personal, rather than business, expense items.

However, in the case of certain paper allocations to patrons, it was later held that such allocations could be deducted or excluded from income at the cooperative level, but would not have to be included in income at the patron level. E.g., *Long Poultry Farms* v. *Commissioner*, 249 F.2d 726 (C.A. 4, 1957), reversing 27 T.C. 985 (1957); *B. A. Carpenter*, 20 T.C. 603 (1953), affd. 219 F.2d 635 (C.A. 5, 1955). One of the principal congressional motives for enacting subchapter T and its comprehensive scheme for taxation of all cooperatives, whether exempt or nonexempt, was to correct this deficiency left by the Revenue Act of 1951. H. Rept. No. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 405, 482-483; S. Rept. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 707, 817.

[12] Through the years patronage dividends have been variously denominated as deductions or exclusions from gross receipts, gross income, or taxable income. See, e.g., fn. 3, *supra; Co-Operative Oil Ass'n* v. *Commissioner*, 115 F.2d 666 (C.A. 9, 1940) (questioning allowance of any deduction without specific statutory authorization), affirming a Memorandum Opinion of the Board of Tax Appeals; *Greene County Farmers Sales Ass'n* v. *United States*, 55 F. Supp. 123 (Ct. Cl. 1944) (rebates deductible as cost of doing business); *Southwest Hardware Co.*, 24 T.C. 75, 86 (1955) (exclusions from "taxable income"); *Home Builders Shipping Association*, 8 B.T.A. 903, 909 (1927) ("part of the cost of goods sold in determining the petitioner's gross income"). The Code now requires that a patronage dividend be treated as "an item of gross income and as a deduction therefrom." Sec. 1382(b). In conformity

1382(b),[13] an organization exempt from tax under section 521(a) is entitled to the additional special deductions of section 1382(c).[14]

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[12] (Continued)

with such description in the Code, we shall refer to an amount paid as a patronage dividend simply as a deduction. See fn. 3, *supra*.

[13] SEC. 1382(b). Patronage Dividends.—In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year—

(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)) with respect to patronage occurring during such taxable year; or

(2) in money or other property (except written notices of allocation) in redemption of a non-qualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred.

For purposes of this title, any amount not taken into account under the preceding sentence shall be treated in the same manner as an item of gross income and as a deduction therefrom.

[14] SEC. 1382(c). Deduction for Nonpatronage Distributions, etc.—In determining the taxable income of an organization described in section 1381(a)(1), there shall be allowed as a deduction (in addition to other deductions allowable under this chapter)—

(1) amounts paid during the taxable year as dividends on its capital stock; and

(2) amounts paid during the payment period for the taxable year—

(A) in money, qualified written notices of allocation, or other property (except non-qualified written notices of allocation) on a patronage basis to patrons with respect to its earnings during such taxable year which are derived from business done for the United States or any of its agencies or from sources other than patronage, or

(B) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid, during the payment period for the taxable year during which the earnings were derived, on a patronage basis to a patron with respect to earnings derived from business or sources described in subparagraph (A).

In general, the taxable income of an exempt cooperative is that portion of its gross income (less usual deductions) which remains after substracting, first, "as an item of gross income and as a deduction therefrom" each of the items described in section 1382(b)(1) and section 1382(b)(2) and, second, deductions allowed in "determining the taxable income" as provided in sections 1382(c)(1) and 1382(c)(2). The only deductions that concern us here are those allowed by sections 1382(b)(1) and 1382(c)(1). Thus, petitioner's taxable income is that portion of its gross income (less usual deductions) which remains after reduction for "amounts paid during the payment period for the taxable year as patronage dividends," section 1382(b)(1), and "amounts paid during the taxable year as dividends on its capital stock," section 1382(c)(1). As a result, although an exempt cooperative's gross receipts may exceed its operating expenses in a particular year, if the exempt cooperative pays enough of such excess as patronage dividends during the payment period for the taxable year or as dividends on its capital stock during the taxable year, then its gross income (and/or its taxable income) may be reduced to zero.

As was the case for taxable years prior to the effective date of subchapter T, a patronage dividend must satisfy a basic threefold test before it may qualify for deduction.[15]

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[15] SEC. 1388. DEFINITIONS; SPECIAL RULES.

(a) Patronage Dividend.—For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies—

(1) on the basis of quantity or value of business done with or for such patron,

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done

In particular the patronage dividend must be "determined by reference to the net earnings of the organization from business done with or for its patrons." Sec. 1388(a)(3).

What is meant by the phrase "by reference to the net earnings?" "Net earnings" itself is a nebulous term. It is not defined in the statute.[16] The phrase "by reference to net earnings" is similarly undefined in the statute.

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[15] (Continued)
with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

[16] Among other things net earnings have, often interchangeably, also been called profits, *Central Co-operative Oil Association*, 32 B.T.A. 359 (1935); net profits, *Mississippi Valley Portland Cement Co.* v. *United States*, 408 F.2d 827, 830 (C.A. 5, 1969); savings, *Co-Operative Oil Ass'n* v. *Commissioner*, 115 F.2d 666, 668 (C.A. 9, 1940); affirming a Memorandum Opinion of the Board of Tax Appeals; net savings, *McLean County Service Co.*, 45 B.T.A. 1004, 1008 (1941); total net income, *Fruit Growers Supply Co.*, 21 B.T.A. 315, 325 (1930), affd. 56 F.2d 90 (C.A. 9, 1932); apparent net income, A.R.R. 6967, III-1 C.B. 287, 289 (1924); net margin, Caplin, "Taxing the Net Margins of Cooperatives," 58 Geo. L.J. 6 (1969); or net proceeds, *Puget Sound Plywood, Inc.*, 44 T.C. 305, 318 (1965). The Exempt Cooperative Association Income Tax Return (Form 990-C) which petitioner used for its taxable year 1964 was divided into three major sections denominated "GROSS INCOME," "DEDUCTIONS," and "TAX." On line 11 of that return petitioner listed the sum of its various receipts including gross profit from its cooperative transactions, interest, rent, and a patronage dividend which it received from a bank. On line 27 of that form it listed the total of the usual deductions to which any normal corporation might have been entitled. Line 28, which in effect is "net earnings," is denominated merely "Line 11 less line 27." On the usual corporation income tax return (Form 1120) which petitioner filed as a nonexempt cooperative for the taxable year 1963, lines 11 and 27 coincide with lines 11 and 27 of Form 990-C, but line 28 is entitled "Taxable income before net operating loss deduction and special deductions." Loosely speaking, then, "net earnings" are what remains of a cooperative's gross receipts after deductions for the usual corporate operating expenses. In the instant case this remainder became the source for such items as (1) income taxes, (2) amounts to be added to petitioner's general reserve, (3) dividends on capital stock, and (4) patronage dividends.

In any event, section 1.1388-1(a)(1), Income Tax Regs., provides that:

> The term "net earnings," for purposes of * * * [the definitional test of section 1388(a)(3)], includes the excess of amounts retained (or assessed) by the organization to cover expenses or other items over the amount of such expenses or other items. For purposes of such * * * [section 1388(a)(3)], net earnings shall not be reduced by the taxes imposed by subtitle A of the Code, but *shall be reduced by dividends paid on capital stock* or other proprietary capital interests. [Emphasis supplied.]

Thus, without comprehensively defining "net earnings" or "by reference to net earnings," the regulations direct that certain items must be treated in certain ways if a calculation of the allowable patronage dividend is to be made "by reference to net earnings." In this sense, the regulations fill in certain definitional gaps in the same way that section 312 fills in many, but not all, of the definitional gaps created by the use of the term "earnings and profits." See Katcher, "What is Meant by Earnings and Profits," 18 N.Y.U. Inst. on Fed. Tax 235, 249 (1960); Andrews, "'Out of Earnings and Profits:' Some Reflections on the Taxation of Dividends," 69 Harv. L. Rev. 1403, 1404 (1956).

In its computation petitioner recognizes that net earnings should be reduced by dividends on capital stock before computing the allowable patronage dividend deduction. However, petitioner reduces its net earnings by the dividend declared on capital stock in the taxable year 1964, but which was not actually paid until the taxable year 1965. Respondent argues that instead petitioner should reduce net earnings by the dividend actually paid on capital stock in the taxable year 1964.[17] Respondent points out that in

[17] In his explanation of adjustments accompanying the notice of deficiency herein, respondent determined that petitioner was entitled to a

computing its taxable income petitioner has deducted the dividend paid on capital stock in the taxable year 1964, while in computing its patronage dividend it has reduced net earnings by the dividend declared on capital stock in

[17] (Continued)
patronage dividend deduction only to the extent of $206,352.64, as follows:

Net earnings before dividends, per return	$750,139.44
Plus: Charitable deductions disallowed	8,486.44
Corrected net earnings before dividends	758,625.88
Less: 10% to general reserve	75,862.59
Less: Dividend *paid* on capital stock during year	476,410.65
Amount available for patronage dividend	$206,352.64

Petitioner claimed a patronage dividend deduction of $430,013. Respondent disallowed $223,660.36, the difference between the claimed patronage dividend deduction ($430,013) and the allowable patronage dividend deduction ($206,352.64). By adding this disallowed patronage dividend deduction to petitioner's loss as shown on its return, respondent eliminated the entire loss and determined that petitioner had a positive taxable income for the taxable year 1964. We note, however, that section 1382(b) describes a patronage dividend deduction as an item of *gross income* and a deduction therefrom. Conversely it would appear that an amount disallowed as a patronage dividend deduction should be added to gross income and not to taxable income. But, whether the disallowed patronage dividend deduction is added to taxable income or to gross income, the end result is the same—a positive taxable income. With no loss to carry back from the taxable year 1964, respondent determined that the previously tentatively allowed carryback adjustment to the taxable year 1961 should not originally have been allowed.

In another part of the explanation respondent had determined that petitioner's taxable income for 1964 (without deduction for charitable contributions) was $79,855.36 and that the charitable deduction would be limited to five percent of that figure, or $3,992.77. See sec. 170(b)(2). As petitioner had claimed $12,479.21 as charitable deductions, respondent disallowed $8,486.44, the difference between the amount claimed ($12,479.21) and the amount allowable ($3,992.77). Petitioner does not question respondent's computation of the allowable charitable deduction, nor does it suggest that respondent's disallowance of $8,486.44 in charitable deductions should not effect an increase in its net earnings for the taxable year 1964. But see *Jacob M. Kaplan*, 43 T.C. 580, 598-599 (1965).

the taxable year 1964. Respondent argues that petitioner should use the same dividend-on-capital-stock figures in both computations and urges that the proper figure is the one corresponding to the dividend actually *paid* in the year in issue. We agree with respondent.

The language of the regulations seems to require that in calculating the allowable patronage dividend deduction, net earnings should be reduced by the dividends *paid* on capital stock. Sec. 1.1388-1(a)(1), Income Tax Regs., *supra*. Petitioner's argument on this issue is unclear. Petitioner has not shown why this regulation is not a reasonable interpretation of the statute. In fact, the conclusory nature of petitioner's argument on this third issue fails to reveal its reliance upon any specific ground which might justify allowance of a net operating loss for the taxable year 1964.

In a different factual situation this regulation has specifically been upheld by the Eighth Circuit. *Des Moines County Farm Service Company* v. *United States*, 448 F.2d 776 (C.A. 8, 1971, affirming per curiam on the basis of 324 F. Supp. 1216 (S.D. Iowa 1971). Respondent's regulation also seems firmly based as applied in the instant case.

Deductions from gross income are allowed for patronage dividends *paid* "with respect to patronage occurring during" the taxable year. Sec. 1382(b)(1). Since the fund from which petitioner could draw a patronage dividend for the taxable year 1964 could not include any amount paid to its members to the extent that such amount was out of earnings other than from member business, section 1388(a), that fund was certainly no greater than the earnings from all sources for the taxable year 1964. But during the taxable year 1964, petitioner *paid* $476,410.65 as a dividend on its capital stock. What effect, if any, did these distributions have on the fund available for payment of a patronage dividend?

If we analogize net earnings to earnings and profits, we would find that the payment by a cooperative of a divi-

dend on its capital stock would tend to decrease the cooperative's net earnings by the amount of such dividend. See sec. 312(a). More importantly, since normal corporate dividends would be considered to be made out of the most recently accumulated earnings and profits, section 316(a), the dividend which petitioner paid on its capital stock in the taxable year 1964 would be deemed to have been made out of the net earnings of that same year. Consequently, we would have to reduce the net earnings for the taxable year 1964 by the dividend actually *paid* on capital stock in that year before we could calculate the allowable patronage dividend.

We might reach the same result by using the same analogy but a different route. Thus, as a general rule where an item is common to both taxable income and earnings and profits available for distribution as normal dividends, consistency requires the use of the same accounting method in computing that item's effect upon both taxable income and such earnings and profits. *Sid Luckman*, 56 T.C. 1216, 1223 (1971), and cases cited; see also sec. 1.312-6(a), Income Tax Regs. In the present case, since a dividend on capital stock is an item common to both petitioner's taxable income and its net earnings available for distribution as a patronage dividend, consistency also might require the use of the same accounting method in computing that item's effect upon both taxable income and such net earnings. In determining its taxable income an exempt cooperative is allowed a deduction for amounts *paid* during the taxable year as dividends on its capital stock. Sec. 1382(c)(1).[18] Therefore, it should also use the figure for the dividend

[18]Note, however, that amounts paid with respect to certain nonmember earnings described in sec. 1382(c)(2) may be deducted by an exempt cooperative in determining taxable income so long as such amounts are paid within the "payment period" for the taxable year. The "payment period" for the taxable year includes the entire taxable year and extends for some 8-½ months beyond the close of such year. Sec. 1382(d).

paid on capital stock during the taxable year in determining the net earnings available for distribution as a patronage dividend.

Respondent's method and the method of section 1.1388-1(a)(1), Income Tax Regs., seem to implicitly recognize the foregoing principles. While the analogy of net earnings to earnings and profits may not be perfect, we believe such analogy would serve as a reasonable basis for upholding the validity of section 1.1388-1(a(1), Income Tax Regs., as applied in this case.

But even if we were to accept petitioner's view that in calculating the allowable patronage dividend net earnings should be reduced by the dividend declared on capital stock of the taxable year, we would be unable to allow a greater patronage dividend deduction than respondent has allowed. The reason is that even under petitioner's computation, a large part of the amount claimed by petitioner as a patronage dividend was not an amount paid "under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid." Sec. 1388(a)(2).

Petitioner's bylaws, which for the taxable year 1964 were different from its bylaws for the taxable year 1963, are the only evidence presented of an obligation to pay a patronage dividend. Respondent's regulations recognize that amounts paid pursuant to the provisions of a cooperative's bylaws whereby the cooperative is obligated to make such payment constitute amounts paid under a written legal obligation. Sec. 1.1388-1(a)(1), Income Tax Regs.

Under the relevant bylaws, 10 percent of petitioner's net earnings for its fiscal year "*shall be* apportioned and set aside to the general reserve fund unless and until such reserve fund shall equal the amount of the paid-in capital stock." (Emphasis supplied.) From the 90 percent of net earnings which remained, "A dividend not to exceed five

percent (5%) *may be* paid to the stockholders computed on the par value of the capital stock held by each stockholder." (Emphasis supplied.) The remainder of the net earnings after reductions for the legal reserve and for the dividend on capital stock *"shall be* apportioned, allocated, and distributed" as patronage distributions. (Emphasis supplied.) Thus, petitioner was under an obligation imposed by its bylaws to make patronage distributions of the net earnings remaining after reductions for the legal reserve and for the dividend on capital stock.

However, since petitioner's directors had the discretion to declare that so much of petitioner's net earnings as equaled five percent of the par value of its capital stock should be distributed to its stockholders as a dividend on capital stock, the obligation imposed by the bylaws extended only to that part of the net earnings which might have remained if the directors had declared a full five percent dividend on capital stock. For the taxable year 1964 petitioner's directors declared a dividend on its capital stock of only 2-½ percent. Petitioner's computation uses this 2-½ percent figure in reducing net earnings for the purpose of ascertaining the fund from which a patronage dividend could be distributed. But, an obligation to pay a patronage dividend is destroyed to the extent that discretion to divert exists. *United States* v. *Mississippi Chemical Company*, 326 F.2d 569, 571 (C.A. 5, 1964); see also, *United Cooperatives, Inc.*, 4 T.C. 93, 107-108 (1944); *Southwest Hardware Co.*, 24 T.C. 75, 83 (1955); *Clover Farm Stores Corporation*, 17 T.C. 1265, 1279-1280 (1952); *Colony Farms Cooperative Dairy, Inc.*, 17 T.C. 688, 693-694 (1951); *Fountain City Cooperative Creamery Association*, 9 T.C. 1077, 1080-1081 (1947), affd. 172 F.2d 666 (C.A. 7, 1949).[19] Thus,

[19]While these last cited cases discuss the excludability or deductibility of patronage dividends of nonexempt cooperatives for years not controlled by subchapter T, the term "patronage dividend" as defined in sec. 1388(a) (and particularly with respect to the requirement of sec. 1388(a)(2)) has substantially the same meaning as had evolved under

even under petitioner's view, only that part of its patronage distributions which exceeded the sum of (1) the amount set aside for the general reserve and (2) an amount equal to five percent of the par value of petitioner's capital stock could have been paid "under an obligation of such organization to pay such amount, which obligation existed before the organization received this amount so paid." Sec. 1388 (a)(2). In this case that excess is slightly less than the amount respondent has allowed.[20]

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[19] (Continued)
the judicial decisions prior to the enactment of subchapter T. Cf. fn. 4, *supra.*

[20] The dividend declared on capital stock in the taxable year 1964 was $245,112.50. Since this sum represents a 2-½ percent dividend on capital stock, a five-percent dividend on capital stock would be twice as large, or $490,225. Petitioner had net earnings of $758,625.88 in the taxable year 1964. By reducing these net earnings by $75,862.59, which represents the 10 percent of net earnings set aside for the general reserve, and $490,225, which represents an amount equal to a five-percent dividend on capital stock, the net earnings available for a patronage dividend would be $192,538.29, or somewhat less than respondent's allowance of $206,352.64.

On a more fundamental level, we wonder if a patronage dividend "deduction" may even be used in calculating net operating losses. Petitioner had no real operating loss in the taxable year 1964. The excess of its gross receipts over its normal operating expenses was over three-quarters of a million dollars. Sec. 172(c) defines "net operating loss" as "the excess of the deductions allowed by this chapter over the gross income." As already pointed out, fns. 3, 12, *supra*, a patronage dividend "deduction" differs from the usual type of deduction. Before 1962 there was strong authority supporting the proposition that a patronage dividend "deduction" was in fact an exclusion from gross income and at least one court has continued to adhere to that view even for years to which subchapter T applies. *Mississippi Valley Portland Cement Co.* v. *United States*, 408 F.2d 827, 831, fn. 6 (C.A. 5, 1969). The statute itself seems to recognize the unusual nature of a patronage dividend deduction since it describes it "as an item of gross income and as a deduction therefrom." Sec. 1382(b). But compare sec. 1.1382-1(a), Income Tax Regs., with Asbill, "Final Regs. on co-ops offer some leeway; but IRS stands firm in certain areas," 18 J. Tax. 368, 369 (1963). Can an "item of gross income" which is "a deduction therefrom" within the meaning of sec. 1382(b) also be a part of the "excess of the deductions allowed by this chapter over the gross income" within the mean-

Petitioner seems to make one further point which we find to be without merit.

On the basis of petitioner's original return for the taxable year 1964 and on the basis of the loss reported by petitioner on that return, respondent allowed petitioner a tentative carryback adjustment of its tax for the taxable year 1961. In its opening brief petitioner's argument seemed to be that respondent is bound by his allowance of that tentative carryback adjustment.

Section 6411(a) provides in pertinent part that:

> A taxpayer may file an application for a tentative carryback adjustment of the tax for the prior taxable year affected by a net operating loss carryback, provided in section 172(b) * * *.
>
> * * * * * *
>
> An application under this subsection shall not constitute a claim for credit or refund.

Section 6411(b) goes on to provide that in general, within a statutorily defined 90-day period—

> the Secretary or his delegate shall make, to the extent he deems practicable in such period, a limited examination of the application, to discover omissions and errors of computation therein, and shall determine the amount of the decrease in the tax attributable to such carryback upon the basis of the application and the examination * * *

Once the decrease in tax attributable to the carryback is determined, it may be applied or credited in various ways or, as was apparently done in this case, it may be refunded to the taxpayer. Sec. 6411(b).

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[20] (Continued)
ing of sec. 172(c)? Cf. Rev. Rul. 65-106, 1965-1 C.B. 126. This question is not raised by the parties and, in light of our disposition of this case, we need not answer it.

Petitioner has overlooked the tentative character of adjustments made pursuant to section 6411. If the Commissioner determines that an amount which has been refunded pursuant to section 6411 should not have been refunded, he may seek to assess such amount as a deficiency in at least two distinct ways. He may assess such amount as a deficiency as if it were due to a mathematical error appearing on the return, sec. 6213(b)(2), or, as appears here, he may proceed by way of a deficiency notice in the usual manner. *John S. Neri*, 54 T.C. 767, 770-771 (1970); *Frank B. Polachek*, 22 T.C. 858, 863-865 (1954); see also *Pearl Zarnow*, 48 T.C. 213, 215 (1967). Consequently, contrary to what petitioner intimates, the Commissioner was not irrevocably bound by his allowance of the tentative carryback adjustment.

In conclusion, petitioner's claim for a net operating loss in the taxable year 1964 must be denied in its entirety.

Reviewed by the Court.

Decision will be entered for the respondent.

UNITED STATES TAX COURT
WASHINGTON

UNION EQUITY COOPERATIVE EXCHANGE,	)	
	)	
Petitioner,	)	Docket
v.	)	No. 43970
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
Respondent.	)	

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion filed May 31, 1972, it is

ORDERED AND DECIDED: That there are deficiencies in income tax of $81,267.77 and $138,164.30 for the taxable years 1961 and 1963, respectively.

(Signed) BRUCE M. FORRESTER

Bruce M. Forrester
Judge

Entered: [Stamped] May 31, 1972

CERTIFICATE OF SERVICE

Three true and correct copies of this petition for writ of certiorari have this day been mailed, postage prepaid, to:

Honorable Scott Crampton
Asst. Attorney General
Tax Division, Department of Justice
Washington, D. C. 20530

Department of Justice, Washington
Tax Division
Attn: Mrs. Carolyn Just
Washington, D. C. 20530

Mr. Howard K. Phillips, Clerk
United States Court of Appeals
Tenth Circuit
Denver, Colorado Mailed one copy